UNITED STATES BANKRUPTCY COURT

FOR THE NORTHERN DISTRICT OF CALIFORNIA

In re

EXCEL INNOVATIONS, INC.,

Debtor.
_____/

Case No. 04-53874-ASW
Chapter 11

MEMORANDUM DECISION GRANTING
DEBTOR'S MOTION FOR SANCTIONS

Debtor Excel Innovations, Inc. ("Debtor") moves for an award of sanctions in the amount of $19,480 against Indivos Corporation and Solidus Networks, Inc. ("Creditors") for Creditors' admitted violation of Bankruptcy Code §1125(b) and Bankruptcy Rule 3017(a) when Creditors served a disclosure statement that had not been approved by this Court -- together with Creditors' Plan of Liquidation -- on all creditors and shareholders of Debtor. Creditors oppose the imposition of sanctions.

Debtor is represented by Scott L. Goodsell, Esq. of Campeau Goodsell Smith. Creditors are represented by Randy Michelson, Esq. of Bingham McCutchen LLP. The matter was briefed, argued, and

submitted for decision. This Memorandum Decision constitutes the Court's findings of fact and conclusions of law, pursuant to Rule 7052 of the Federal Rules of Bankruptcy Procedure.

I.

FACTS

Debtor filed its chapter 11 bankruptcy petition on June 17, 2004. On March 4, 2005, Creditors filed a plan and disclosure statement and set a hearing to have the Court approve the disclosure statement. On that day, Creditors also served a copy of the unapproved disclosure statement together with Creditors' "Plan of Liquidation for Excel Innovations, Inc. Proposed by Indivos Corporation and Solidus Networks, Inc." on all of Debtor's creditors and shareholders. There is no evidence in the record that this service was done for tactical reasons.

On March 23, 2005, Debtor's counsel called Creditors' counsel and informed her that the unapproved disclosure statement had been served on all of Debtor's creditors and shareholders in violation of Bankruptcy Rule 3017(a) ("Rule 3017").[1] On that same day,

[1] Federal Rule of Bankruptcy Procedure 3017(a) provides:

> (a) Except as provided in Rule 3017.1, after a disclosure statement is filed in accordance with Rule 3016(b), the court shall hold a hearing on at least 25 days' notice to the debtor, creditors, equity security holders and other parties in interest as provided in Rule 2002 to consider the disclosure statement and any objections or modifications thereto. The plan and the disclosure statement shall be mailed with the notice of the hearing only to the debtor, any trustee or committee appointed under the Code, the Securities and Exchange Commission and any party in interest who requests in writing a copy of the statement or plan. Objections to the disclosure statement shall be filed and served on the debtor, the trustee, any committee appointed under the Code, and any other entity designated by the court, at any time before the disclosure statement is approved or by an earlier date as the court may fix.

Creditors filed and served a notice of withdrawal of the disclosure statement on all parties served on March 4, 2005, and removed the hearing to approve that disclosure statement from the Court's calendar.

At a hearing on March 25, 2005, Debtor informed the Court of the March 4 mailing and expressed serious concern about the impact the mailing had on its creditors and shareholders. Creditors' liquidating plan proposed Debtor would cease doing business upon consummation of the plan. The plan also proposed a settlement of various claims and rights Debtor holds against Creditors through a lump sum payment to the estate by Creditors. Debtor claimed the dissemination of Debtor's purported liquidation, and settlement of Debtor's claims against Creditors for far less than Debtor believes they are worth, had a negative impact on the potential investment of additional funds Debtor was seeking from its shareholders. The Court ordered Creditors and Debtor to meet and confer on a possible mutually agreed means to resolve the matter and continued the hearing to April 5, 2005.

At the April 5, 2005 hearing, following a full discussion of the matter among the Court and counsel, the Court determined it was appropriate for the Office of the United States Trustee ("UST") to conduct an investigation into the impact of the mailing on Debtor's creditors and shareholders. Counsel for Creditors agreed that the Court had the authority to require the UST investigation. The Court set up a briefing schedule for Debtor to provide proposed

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> In a chapter 11 reorganization case, every notice, plan, disclosure statement, and objection required to be served or mailed pursuant to this subdivision shall be transmitted to the United States trustee within the time provided in this subdivision.

questions for the UST and to permit Creditors and the UST to comment on those questions. At a continued hearing on April 26, 2005, the Court approved revised questions and instructed the UST to identify and contact ten of Debtor's creditors and shareholders, ask them the prescribed questions, and prepare a final report of the responses.

The UST filed its report on May 17, 2005. That report indicated that the Rule 3017 violation negatively impacted one of the ten people interviewed by the UST. Debtor has incurred $19,480 in attorneys' fees responding to Creditors' Rule 3017 violation and seeks sanctions in that amount against Creditors.

II.

DISCUSSION

The primary issue before this Court is whether the Court can impose sanctions for violations of Rule 3017 and, if so, must the party requesting sanctions show bad faith before such sanctions can be awarded.

A. Parties' Positions

Debtor asserts this Court has power under its inherent powers under Bankruptcy Code §105(a) to sanction a party who willfully disobeys a court order or acts in bad faith, although a finding of bad faith is not obligatory. In re Marvel, 265 B.R. 605 (N.D. Cal. 2001). Courts uniformly award the non-violating parties their attorneys' fees as compensation for Rule 3017 violations. In re Rook Broadcasting of Idaho, Inc., 154 B.R. 970 (Bankr. D. Idaho 1993)("Rook Broadcasting"); In re Clamp-All Corp., 233 B.R. 198

(Bankr. D. Mass. 1999) ("Clamp-All"); In re California Fidelity, Inc., 198 B.R. 567 (9th Cir. BAP 1996) ("California Fidelity"). The courts in Rook Broadcasting, Clamp-All, and California Fidelity all granted sanctions for Rule 3017 violations without making findings of bad faith and this Court has authority to do the same.

In addition, 28 U.S.C. §1927 ("§1927") permits an award of attorneys' fees against an attorney who multiplies the proceedings in any case as to increase costs unreasonably and vexatiously -- and does not require a finding of bad faith. In re Peoro, 793 F.2d 1048 (9th Cir. 1986) ("Peoro").

Creditors agree that the Court's ability to impose sanctions in this circumstance stems from the Court's inherent powers under Bankruptcy Code §105(a). However, Creditors argue that before the Court can impose sanctions under §105(a), the Court must make a specific finding of bad faith. In re Dyer, 322 F.3d 1178, 1197 (9th Cir. 2003) ("Dyer"); Zambrano v. Tustin, 885 F.2d 1473, 1476 (9th Cir. 1989). Creditors admit they violated Rule 3017; however, they argue that there is no showing of fraud, bad faith, or intentional or deliberate misconduct in this case so sanctions cannot be awarded.

Moreover, Creditors argue that the creation of electronic court filing ("ECF") system means attorneys will inevitably violate Rule 3017 because upon the filing of a document, all parties on the ECF system receive notice the document was filed and a link to that document. Thus, parties receiving ECF notice will receive the disclosure statement without requesting it.

Creditors assert that, if this Court determines that it can grant sanctions, there is no admissible evidence that Debtor

incurred attorneys' fees to cure any alleged harm caused by Creditors as in Clamp-All, California Fidelity, or Rook Broadcasting. Further, Creditors contend that Debtor's attorneys' fees are excessive and should be reduced as in Rook Broadcasting, where the court awarded one-half of the fees for the Rule 3017 violation.

Finally, Creditors move to strike (1) Debtor's assertion in its motion that Debtor received various phone calls from concerned shareholders based on the fact that Debtor offers no competent evidence in support of the allegation and it is inadmissible hearsay; (2) page 2, lines 3-5 of the declaration of Debtor's chief financial officer Ruth Hamilton filed in relation to the June 1 status conference that says that, based on responses to her, Ms. Hamilton believes that the transmission of Creditors' unapproved disclosure statement had an adverse effect on Debtor's shareholders' willingness to make further investments in Debtor based on the grounds that it is an improper conclusion, wholly speculative and lacks foundation since it is based on inadmissible hearsay; and (3) Exhibit A of the Hamilton declaration based on the ground that it is inadmissible hearsay.

B. Analysis

Contrary to Debtor's assertions, this Court has no authority to grant sanctions under 28 U.S.C. §1927. Debtor relies on Ninth Circuit authority in Peoro for the proposition that this Court has authority to grant sanctions under 28 U.S.C. §1927. However, the Ninth Circuit in In re Perroton, 958 F.2d 889 (9th Cir. 1992) ("Perroton") held that bankruptcy courts are not courts of the

United States under 28 U.S.C. §451. The Bankruptcy Appellate Panel held in In re Sandoval, 186 B.R. 490 (9th Cir. 1995), that under the reasoning of Perroton, the Bankruptcy Appellate Panel (and seemingly bankruptcy courts) lack authority to impose sanctions under 28 U.S.C. §1927.

Creditors assert that this Court cannot impose sanctions without a finding of bad faith. The Court disagrees. Under Dyer, this Court can sanction violations of the Bankruptcy Code and Rules without a finding of bad faith. In Dyer, the creditor recorded a deed of trust post-petition in violation of the automatic stay. The bankruptcy court determined that the violation was willful and in bad faith and the chapter 7 trustee was entitled to compensatory and punitive damages. The Ninth Circuit upheld the compensatory damages sanction, but concluded punitive damages were not available under §105(a) or the bankruptcy court's inherent sanction authority. The Dyer court held:

> "The standard for finding a party in civil contempt is well settled: The moving party has the burden of showing by clear and convincing evidence that the contemnors violated a specific and definite order of the court." Because the "metes and bounds of the automatic stay are provided by statute and systematically applied to all cases," there can be no doubt that the automatic stay qualifies as a specific and definite court order. [Citations omitted.]
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> In determining whether the contemnor violated the stay, the focus "is not on the subjective beliefs or intent of the contemnors in complying with the order, but whether in fact their conduct complied with the order at issue." [Citations omitted.]

Dyer, 322 F.3d at 1190-91.

Under Dyer, Creditors' violation of Rule 3017 and Bankruptcy Code §1125(b) qualifies as a specific and definite order for sanction purposes. This Court is only awarding Debtor its

attorney's fees to compensate Debtor for its out of pocket costs in having to address Creditors' violation of Rule 3017. The Bankruptcy Appellate Panel in regard to a violation of Bankruptcy Code §1125(b) expressly held:

> It is within the inherent authority of the bankruptcy court to sanction conduct that violates the bankruptcy laws. Thus, after determining that Duff violated §1125(b), the bankruptcy court had the authority to impose sanctions. [Citations omitted.]

California Fidelity, 198 B.R. at 573.

It makes sense that a bankruptcy court can impose sanctions solely based on violations of the Bankruptcy Code and Rules. Bankruptcy Code §1125(b) and Rule 3017 protect creditors and are key to the confirmation process. Regarding the purpose of Bankruptcy Code §1125(b), the Bankruptcy Appellate Panel states:

> The purpose of a disclosure statement is to give all creditors a source of information which allows them to make an informed choice regarding approval or rejection of a plan. Section 1125(b) provides that no one is permitted to "solicit" plan acceptances or rejections until a disclosure statement has been approved by the bankruptcy court and transmitted to creditors along with the proposed plan of reorganization. At a minimum, §1125(b) seeks to guarantee that a creditor receives adequate information about the plan before the creditor is asked for a vote. [Citations omitted.]

California Fidelity, 198 B.R. at 571. Regarding Rule 3017, the Rook Broadcasting court states:

> The Bankruptcy Code's requirement of court approval of a disclosure statement, combined with Rule 3017's restrictions on dissemination of an unapproved disclosure statement clearly contemplates some creditors need to be protected against misinformation. Creditors who are not knowledgeable or informed with regard to the debtors' affairs will not be presented with information regarding the debtors and the proposed plan until the court has determined the disclosure statement contains information adequate for the creditor to make an informed choice.

Rook Broadcasting, 154 B.R. at 976. Bankruptcy Code §1125(b) and Rule 3017 clearly are designed to protect creditors from the confusion and misunderstanding that can accompany the dissemination of unapproved plans and disclosure statements.

Under Dyer, bad faith or subjective intent is not a necessary finding for the imposition of sanctions under the bankruptcy court's civil contempt authority. However, bad faith or willful misconduct -- consisting of something more egregious than mere negligence or recklessness -- is required if the bankruptcy court imposes sanctions under its inherent sanction authority. As stated by the Dyer court:

> We do discern a difference [regarding whether a bankruptcy court's inherent sanction powers and the civil contempt powers under Bankruptcy Code §105(a) are interchangeable]. Civil contempt authority allows a court to remedy a violation of a specific order (including "automatic orders, such as the automatic stay or discharge injunction). The inherent sanction authority allows a bankruptcy court to deter and provide compensation for a broad range of improper litigation tactics. [Citation omitted.]
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> The inherent sanction authority differs from the civil contempt authority in an additional respect as well. Before imposing sanctions under its inherent sanctioning authority, a court must make an explicit finding of bad faith or willful misconduct. In this context, "willful misconduct" carries a different meaning than the meaning employed in the context of determining whether an individual is entitled to damages under §362(h) or a contempt judgment under §105(a) for an automatic stay violation. With regard to the inherent sanction authority, bad faith or willful misconduct consists of something more egregious than mere negligence or recklessness. Although "specific intent to violate the automatic stay" may not be required in the contempt context, such specific intent or other conduct in "bad faith or conduct tantamount to bad faith," is necessary to impose sanctions under the bankruptcy court's inherent power. [Citations omitted.]

Dyer, 322 F.3d at 1196. Here, the sanctions for the Rule 3017 violation are imposed under the Court's civil contempt authority, so a finding of bad faith or willful misconduct is not necessary.

If the Court adopted Creditors' theory regarding the imposition of sanctions, even if the dissemination of the unapproved disclosure statement had been shown to cause great direct economic damage to Debtor, the Court would lack power to enforce the Bankruptcy Rules if the violation was not shown to be in bad faith. It would be a sorry situation if the Court could not compensate parties for violations of the Bankruptcy Rules -- even in cases of negligence or recklessness -- without an express finding of bad faith. Such a notion is contrary to express Ninth Circuit authority.

Moreover, the courts in Rook Broadcasting, Clamp-All, and California Fidelity imposed sanctions for violating Bankruptcy Code §1125(b) and Rule 3017, and this Court finds it has authority to impose compensatory sanctions under those cases.

In Rook Broadcasting, creditor Harris filed his proposed plan that provided for Harris' purchase of the debtor's radio station. In connection with the filing, Harris mailed a copy of his proposed, but unapproved, disclosure statement to substantially all of the debtor's creditors. The disclosure statement was accompanied by a notice of hearing, but was captioned as though it had been court-approved. At a subsequent hearing, the disclosure statement was denied approval. As a consequence of the mailing of Harris' unapproved disclosure statement, the debtor received numerous phone calls from creditors inquiring whether the radio station had been sold to Harris since the debtor had a competing

plan that sold the radio station to another entity. The Rook Broadcasting court stated: "Such confusion and misunderstanding could have been avoided had Harris complied with the clear language of Rule 3017." Rook Broadcasting, 154 B.R. at 976. As a sanction for the improper distribution of the unapproved disclosure statement, the court sanctioned Harris one-half of the attorneys' fees and costs incurred in prosecuting the motion to delay consideration of Harris' plan.

In Clamp-All, two creditors sent a copy of their competing plan and unapproved disclosure statement to all creditors as part of their objection to approval of the debtor's disclosure statement during the debtor's period of exclusivity. The Clamp-All court held that the bankruptcy court is obligated to give chapter 11 debtors every reasonable opportunity to present a plan of reorganization and subordinated the claims of the offending creditors to all other non-insider claims and proposed to award the debtor such attorneys' fees as the court may subsequently allow.

The court in California Fidelity awarded attorneys' fees for violating Bankruptcy Code §1125(b) where no particularized harm was shown. In California Fidelity, the debtor's president disseminated a letter to the debtor's creditors in advance of any approved disclosure statement telling creditors to reject the joint plan of the creditors' committee and the chapter 11 trustee. The joint plan was subsequently confirmed. The Bankruptcy Appellate Panel approved the bankruptcy court's determinations that there was no harm from the dissemination of the letter only because of the expeditious response of the various parties and that it was nevertheless appropriate for the Court to impose sanctions in an

amount that compensated the parties involved. California Fidelity, 198 B.R. at 573.

In this case, the mailing of the unapproved plan and disclosure statement took a substantial amount of coordinated effort on the part of Creditors -- the plan and disclosure statement had to be copied and envelopes labeled and stamped. This is not a case where a piece of paper accidently was included with another pleading and mailed to creditors. Thus, the service of the unapproved disclosure statement was willful under Dyer. Moreover, the UST's investigation showed that in at least one instance, the dissemination of the unapproved disclosure statement negatively impacted one of Debtor's shareholders. This is the exact type of incident that Rule 3017 was designed to prevent and was the basis for sanctions in Rook Broadcasting.

The Court regards Creditors' Rule 3017 violation as serious and the potential harm to a debtor (and to this Debtor) in this situation as very real. While negligent or reckless -- not intentional -- Creditors' actions caused damage to Debtor. Debtor had to bring a motion to the attention of the Court and fight for the UST investigation over the vigorous objection of Creditors. This damage is aside from and in addition to damages because the views of Debtor's creditors and shareholders may have been negatively affected by the dissemination of the disclosure statement.

Debtor's concerns about the possible negative impact of Creditors' negligent mailing of the disclosure statement and plan were reasonable. The Court ordered the UST to investigate possible damage to Debtor and some negative impact was found. Moreover,

Debtor's attorneys' fees are reasonable and were largely caused by Creditors' opposition to any investigation being conducted. If Creditors had cooperated and not opposed the limited investigation, Debtor would have incurred far less in attorneys' fees. The fees were incurred substantially because Creditors opposed any investigation. The damages provided to Debtor by this sanctions order merely compensate Debtor for the out of pocket attorneys' fees in bringing this matter to the Court's attention and asking Court (over Creditors' objection) to order an investigation. No compensation is provided for the specific effect on Debtor of the loss of investors or other economic damage caused by dissemination of the disclosure statement and plan. Creditors are not being punished -- just required to pay for the direct out-of-pocket costs of their own negligent or reckless behavior.

All of Debtor's requested attorneys' fees were incurred as a direct result of Creditors' Rule 3017 violation. The fees were incurred researching the consequences of the Rule 3017 violation, appearing at several status conferences to determine the impact of the violation, drafting questions for the UST to ask Debtor's shareholders and creditors, and drafting this motion for sanctions. Debtor should be compensated for the cost of addressing the harm caused by Creditors' actions. Sanctions are imposed against Creditors in the amount of $19,480.

The Court disagrees with Creditors' argument that the ECF requires that Creditors would violate Rule 3017 when filing a proposed disclosure statement. As the Court understands the system, under the ECF, attorneys that have requested notification of the filing of documents in a bankruptcy case receive an

electronic notification that a document has been filed and a link to that document. This is akin to an attorney filing a request for special notice and a party serving a disclosure statement where a request for special notice has been filed. That scenario is very different from the one here where Creditors served by mail the unapproved disclosure statement and plan on all of Debtor's creditors and shareholders thus giving the definite, but erroneous, impression that the disclosure statement had been approved by the Court.

Regarding Creditors' motion to strike, the Court is not relying on any of the evidence objected to by Creditors in ordering the sanctions, so the motion is moot.

CONCLUSION

For the reasons stated above, Creditors are sanctioned $19,480 for violating Rule 3017. Counsel for Debtor shall prepare and submit a form of order in accordance with this Memorandum Decision, after review as by counsel for Creditors.

DATED:

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ARTHUR S. WEISSBRODT
UNITED STATES BANKRUPTCY JUDGE

Case No. 04-53874-ASW
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